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PASS TO EUR/ERA: JONATHAN KESSLER AND BEN ROCKWELL
PASS TO TREASURY/IA: LUKAS KOHLER

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Summary

¶1. (SBU) While the Greek banking system has not been hit by first-round effects of the global financial crisis given its limited exposure to the complex financial products at the center of the storm, it has been affected by the ensuing freeze in the capital markets and the increased cost of raising liquidity. Initially declaring Greek banks safe from the crisis, the Karamanlis government recently followed the example of UK Prime Minister Gordon Brown and others in Europe by developing a 28-billion Euro bank aid plan. The GoG,s plan was light on details when first announced, but the government last week made public concrete conditions for participating banks. These conditions include mandatory state participation in participating banks share capital, caps on executive pay and dividends to shareholders, and a state representative on bank boards. Prior to the publication of these details, most of Greece,s largest banks had said they would avail themselves of the package, and most of the smaller banks were expected to follow suit. Recent press coverage, however, indicates that the larger banks may be rethinking the assistance. Over the weekend, Greece,s largest private bank, the National Bank of Greece, indicated it is reconsidering the pros and cons of participation, which may be a reaction to the government,s new conditions. Moreover, the global crisis has exposed weaknesses in the Greek economy with which the GoG will need to contend if it is to weather the financial storm in the longer run. One way to address these weaknesses will be to develop a 2009 budget that has strong policy aims (e.g., decrease in size of public sector and protection of the vulnerable) and is underpinned by credible targets and assumptions. End Summary.

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The Global Crisis: Impact Hits Greece through Jitters
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¶2. (SBU) As the international crisis hit, the government firmly maintained that Greek banks were insulated because their exposure to so-called toxic debt instruments was limited. This is largely because for the last decade, Greek banks sought to exploit traditional investment opportunities in the nascent but expanding markets of Greece and Southeast. Europe. Since growth in these markets was high, the returns on investments were high enough to satisfy Greek banks, appetites without having to turn to riskier investment tools (e.g., credit derivatives). The GoG also maintained that Greek banks had healthy capital bases and were stable, with sensible asset-equity ratios and with an average loan-to-deposit ratio of approximately 90 percent for the sector as a whole, meaning that banks, dependence on

international and capital markets is small.

¶3. (SBU) Nonetheless, the global crisis began to have some impact on banks here in late September, as the level of fear increased in response to what was happening in financial markets elsewhere, and people began to question whether their deposits were safe in Greek banks. Following public statements in early October to try to calm depositor jitters in (see reftel), the GoG submitted legislation to Parliament on October 10 to increase its deposit insurance from 20,000 Euros per person per account to 100,000 Euros per person per account. This was largely a result of the October 7 EU finance ministers agreement, but also in response to higher than average withdrawals from the Greek banking sector. According to the Bank of Greece (Greece,s central bank), from late September until approximately October 10, the Greek banking sector experienced a "mini-bank run," with deposit withdrawals from banks increasing from a usual daily average of 30-40 million Euros to 130-140 million euros. The government,s move helped calm Greek depositor jitters, and daily withdrawals subsided to more normal levels the following week. Parliament passed this legislation on October 23. (Note: Greece,s guarantee deposit scheme is financed by member banks, each of which pays into a fund according to its level of deposits and share of the Greek banking sector. End Note.) In addition, statements by senior GoG leaders indicate the government remains firm in its political commitment to guarantee all deposits of Greek citizens in Greece (see reftel).

The 28-Billion Euro Aid Plan

¶4. (SBU) Paralyzed capital markets and higher borrowing costs were beginning to manifest their impact on Greece,s banking sector in other ways as the rate of credit expansion slowed in September. In response, and following the model established by UK Prime Minister Gordon Brown,s bank rescue plan, the Karamanlis government on October 15 announced a 28-billion Euro aid plan for Greek banks. The 28 billion is broken up as follows: (1) the government will guarantee up to 15 billion in bank-issued bonds/other paper in exchange for a fee and/or secure collateral from each participating bank; (2) the government will issue up to 8 billion in new government bonds, turning over the bonds to banks and allowing them to sell these in the repurchase market in exchange for a fee and/or secure collateral; and (3) up to 5 billion to be made available to banks to increase their share capital in exchange for the sale of preferred shares to the government. Initially, very few details were released on how the plan would be implemented on a bank-by-bank basis and what the conditions of participation would be. Finance Minister George Alogoskoufis justified the plan publicly as being part of a pan-European effort to restore confidence in the financial system. He stated that all banks, including Greek banks, were suffering a crisis of confidence, higher interest rates and lack of liquidity. The goal of the government,s plan, according to Alogoskoufis, was not to bailout Greek banks, but rather to shield the Greek economy from an unprecedented crisis. Alogoskoufis stressed that Greek banks would be at a disadvantage to their EU counterparts if the GoG did not extend support as other EU countries had done. Moreover, some international financial commentators have voiced concern over the level of Greek banks, exposure in Balkan countries such as Romania, Bulgaria, and Serbia as those countries, banks and real economies get hit by the crisis.

¶5. (SBU) The GoG made additional details publicly available on October 30. The institutions which choose to participate in the GoG,s bank plan must accept the following conditions: (1) state participation in their share capital through the sale of preferred share to the government; (2) caps on

salaries of bank executives (no more than the Bank of Greece Governor); (3) a 35 percent cap on dividends to stockholders; (4) the scrapping of bonuses to executives; and (5) a state representative on the participating bank's board who will have veto rights regarding distribution of profits and benefit policies. The GoG has set up a supervisory council made up of the Minister of Finance and the Central Bank Governor, among others, to oversee implementation of the package. Each bank must decide whether to participate in the plan by February 1. The government has not indicated publicly what it will charge (in fees) in exchange for the liquidity instruments, how much liquidity and capital it will make available to each bank, and what it will accept as secure collateral in exchange for the guarantees and bonds.

Bank Reaction and Participation

¶6. (SBU) The banks, position on participation has evolved as the government has added meat on the bones of its plan. In several meetings with A/DepEconCouns, senior officials at Greece,s five largest private banks (in order of size, National Bank of Greece, EFG Eurobank, Alpha Bank, Bank of Piraeus, and Emporiki Bank) indicated shortly after the plan was announced that they did not need the assistance, and did not have enough details on the government,s conditions. One week after the government announced the plan, Deputy Governor of the Central Bank Panayiotis Thomopoulos and head of the Council of Economic Advisors George Sfakianakis both indicated to A/DepEconCouns that the GoG was still working on the conditions of participation and a methodology for determining the amount of assistance and fee per bank. Following an October 23 meeting with the GoG, six of Greece,s largest seven banks (the five largest private banks plus Greece,s two state-owned banks) said publicly they would take part in the assistance. (Note: Only Emporiki indicated immediately following the meeting it would not participate in the Greek plan, opting instead to take part in the French plan under its parent, Credit Agricole Group. End Note.) The government expects smaller financial institutions to participate as well. Thus far, of the latter, only Marfin Investment Group has indicated it will not participate, publicly voicing criticisms that the package is inadequate

and unfair and creates questions over the condition of the domestic banking system.

¶7. (SBU) Since the GoG announced its conditions on October 30, there are indications that some of the larger banks may be rethinking their participation. Paul Mylonas, Chief Economist and Chief of Strategy for the National Bank of Greece, told A/DepEconCouns on October 31 that despite press reports indicating National Bank was on board, his bank has not decided whether to participate. Takis Arapoglou, CEO and chairman of National Bank, confirmed this position during an interview with To Vima newspaper on Nov. 2. Arapoglou told To Vima that National Bank is able to cope with worsening credit conditions since it has "excess liquidity" of 2.0-2.5 billion euros and a 10 billion Euro loan portfolio it can leverage for extra liquidity as needed. (Note: The excess liquidity is likely a reference to National Bank's low loan/deposit ratio of 80 percent, one indication it has deposits available for further loans or to rollover current debt. It is not clear what caused this about face by National Bank, but during A/DepEconCouns, discussion with Mylonas, it was clear that he and others at the Bank were frustrated by the GoG,s new terms specified on Oct. 30. In particular, he seemed agitated by the GoG,s insistence that those who opt into the package must issue preferred shares to the government in exchange for an increase in share capital. He also appeared to be bothered by the caps on pay and dividends. End Note.) There are some indications in the press that other banks may also be questioning whether or not

to take the package in exchange for what many deem arbitrary conditions.

¶8. (SBU) Mylonas told A/DepEconCouns that the government has agreed to a methodology for assessing a fee for the guarantees and bonds that is based on two components: a fixed, standard component across banks and a component specific to each participating bank that factors in that particular institution's spreads in the credit default swap (CDS) market. Mylonas also indicated that the GoG has established a formula for how much of each instrument each bank will get based on bank size. Under the fee methodology, Mylonas believes that National Bank would be charged approximately a 100 basis point premium (over the government,s cost of borrowing) for the guarantees and bonds (approximately 50 basis points for the common component and 50 basis points based on its CDS spreads). He does not yet know how much of each instrument his bank will be allowed to access if it participates, but the GoG has told National Bank's senior management that they would receive approximately 1 billion of the 5 billion Euro capital injection in exchange for the government buying some portion of preferred shares at a 10 percent yield. (Note: Mylonas indicated the number of shares is still in question, but likely will be based upon market pricing of National Bank's stocks, since they are traded on the Athens Stock Exchange. End Note.)

¶9. (SBU) Mylonas and officials at Alpha Bank, Eurobank, and Piraeus bank do not have a clear understanding of what type of secure collateral the government will demand in exchange for the guarantees and bonds. The legislation does not specify, and bank officials question whether such an exchange can be legally executed. Mylonas was adamant that pledging collateral to the GoG would violate the "negative pledge clause" the bank inserts in most of its credit instruments. (Note: A negative pledge clause is a contract term which says that the borrower will not pledge the collateral to anyone else, including new creditors. This is used to ensure that the senior creditors or those at the front of the line have first pickings on the collateral before parties at the back of the line. A breach of this clause could give rise to an event of default. End Note.) Mylonas believes the GoG will back away from this condition.

Implications for Greece,s Economy, Budget, Debt

¶10. (SBU) Despite the crisis, limited impact in the banking sector thus far, it has exposed weaknesses in the Greek economy with which the GoG will need to contend. The rate of growth, already slowing in the first two quarters of 2008 (to 3.5 percent, down from 3.8 percent in the first two quarters of 2007), is now projected by external analysts to slow anywhere from 3.2 percent (IMF projection) to 2.4 percent (Economist Intelligence Unit projection) for 2008 as a whole. While more robust than the rate projected in the Eurozone

(1.4 percent, according to the Economic Commission), it is considerably down from Greece,s 2003-07 average of 4.3 percent. Projections for 2009 range from 2.5 percent (European Commission) to 2 percent (IMF). (Note: The GoG,s projections for 2008 and 2009, as reflected in the draft 2009 budget, continue to be a robust but unrealistic 3.4 and 3.0 percent, respectively. End Note.) The slowdown in growth is due primarily to a fall in investment and consumption, both of which had already been on the decline due to the cooling of the Greek real estate market. These drivers of growth are likely to continue to slow as a result of tightening credit conditions, the higher costs of borrowing, and the global slowdown. In the short-run, these factors may help alleviate pressure on prices, increase the domestic rate of savings, and help shrink Greece,s current account deficit (projected to be over 14 percent in 2008, the highest in the EU).

¶11. (SBU) In the longer-run, to return to strong growth rates, Greece will need to place structural and administrative reforms at the top of its agenda in order to shrink the size of its public sector and increase its competitiveness. This will mean placing less of an emphasis on fiscal consolidation as a means to an end, and more as a means of helping to achieve specific goals (e.g., shrinking the deficit through both targeted tax increases and spending decreases) that are underpinned by credible policies, targets and assumptions. The draft 2009 budget, for example, is largely viewed as being unrealistic both in terms of its assumptions (growth as highlighted above; fiscal deficit of 2.3 percent of GDP in 2008, despite the Eurostat upward revision of the 2007 deficit from 2.8 percent to 3.5 percent) and in its aims (raising an additional 4 billion euros through new taxes in the face of slowing growth).

¶12. (SBU) Efforts to control deficit spending largely have stalled the last two years, and the government,s recent efforts to shrink the deficit are not viewed as credible because they are not backed by a serious commitment and commensurate efforts to curb government spending. The GoG,s claims that missing its deficit targets in 2007 and 2008 is due to the crisis also is not credible, since before the crisis hit, revenues for the first half of the year were up only by 3.9 percent (against a 12.5 percent target) and spending was up by 10 percent (against a 8.3 percent target). While the beginning of the slowdown may be partially to blame, so too are unrealistic revenue targets and the Karamanlis government,s unwillingness to take the difficult steps necessary to bring down the deficit. For example, rather than containing wage growth, Minister Alogoskoufis agreed to a series of public sector wage increases in 2008 that will add approximately 8.9 percent to payroll costs in 2008 alone. To pay for these new expenditures as well as to make up for lower tax collections, the government pushed through a hasty new tax plan in late August that they hope will raise approximately 4 billion euros in revenues through 2009 (1.4 billion this year, and at least 2.4 billion next year).

¶13. (SBU) While the GoG is hoping that the EU will ease its budget deficit limit (3 percent of GDP) to give countries space to manage a soft landing from the recent crisis, a higher budget deficit will mean that the government will need to borrow more to finance its fiscal spending. In the draft 2009 budget, the GoG projects a borrowing need of 43-44 billion euros in 2009. Absent cuts in the GoG,s spending program, the need to finance the 28-billion bank package will increase the government,s borrowing needs and its overall level of debt, which was already high at 94.8 percent (public debt) in 2007. Another complication is that this new debt will all need to be financed at a much higher interest rate, since the government,s cost of borrowing has gone up as a result of (1) the crisis, which has caused investors to seek haven in safer investments, and (2) the market's perceptions of increased risk in Greece, stemming from the highest budget and current account deficits in the Eurozone. (Note: The government,s lack of credibility on its fiscal targets and widening of its fiscal deficit led to Fitch Ratings downgrading its country outlook from "positive" to "stable" in mid-October. The spread between Greek government 10-year bonds and the corresponding German bond reached an all-time high last week of over 160 basis points. End Note.) Depending on the profile of the government,s debt, Greece,s higher spreads could place further pressure on the government,s interest bill in the 2009 budget and beyond.

Public Reaction

¶14. (SBU) The package is likely to pass Parliament, but the

government has not won the hearts and minds of its public. The Karamanlis government,s justification of its bank aid package has been weak thus far. The Greek public has seized upon the idea that the government is bailing out wealthy banks at a time when the average Greek pensioner, small business person and home owner is growing more desperate as a result of what are perceived to be shrinking incomes, increasing taxes and exploding (although abating recently) consumer prices. More recently, Prime Minister Karamanlis and Minister Alogoskoufis have tried selling the package as necessary to the health of the Greek economy. They have even gone so far as to say that the package will add 500 million euros to state coffers annually, all of which can be used to help support the poor and pay for public works.

Comment

¶15. (SBU) At a time when this government is entrenched in a series of corruption probes that have resulted in the resignation of two senior officials, the government,s bank aid may only serve to reinforce the common person's belief that this is a government by the rich for the rich. Opposition parties, meanwhile, have both exploited and fed this sentiment by calling the government,s bank aid plan a "crime against the people." Our impression, however, is that the bank aid plan reflects the government,s legitimate attempt to respond to a complex situation at a time of tremendous uncertainty. While many details of the plan are still evolving, so to are the crisis and its impact on Greece and other countries. Many things remain unknown, including the effect that a slowdown in the Balkans will have on Greek banks that are invested there and how long interest rates will stay up. While Greek banks may be hesitant to accept assistance right now, this may be because they are trying to get the GoG to back off of some of its terms. As the crisis continues to unfold, and the impact spreads to the real economy globally, these banks may decide to take any terms the GoG offers to stay competitive and to protect their investments in regions like Southeast Europe, where the impact on the real economy may become more acute. Of course, being Greece, there will also certainly be an element of making it up as they go along. End Comment.
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